STANLEY SURREY, THE AMERICAN LAW INSTITUTE INCOME TAX PROJECT, AND THE NORMATIVE STRUCTURE OF THE INCOME TAX

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I

INTRODUCTION

Stanley Surrey is best known among American tax experts for introducing the idea of including in the federal budget a list of those features of the income tax that constitute "tax expenditures."[1] Such provisions give benefits to activities and industries that could just as easily have been provided through direct payments. Surrey was not the first to point out that the Internal Revenue Code contained many provisions that had the same effect as a direct subsidy.[2] But Surrey was the primary actor in developing the concept as a focal point for policy discussions and in persuading Congress that a separate accounting of these measures should be formally made. As a result of his efforts, the federal budget has included a tax expenditure budget since 1974.

In his proposals for a tax expenditure budget, Surrey clearly relied on the possibility of a set of structural norms that defined the income tax base. Such a

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1. *See generally* Assaf Harpaz & C. Eugene Steuerle, *Stanley Surrey's Lasting Influence*, 86 LAW & CONTEMP. PROBS., no. 2, 2023, at 167; Jonathan Barry Forman, *Origins of the Tax Expenditure Budget*, 30 TAX NOTES 537 (1986) (attributing the initial analysis behind the concept to work by Gabriel G. Rudney, including two of his papers: Federal Tax Aids: A Proposal for Public Accounting (Aug. 1967) (unpublished manuscript) and *Developing Tax Expenditure Accounting*, *in* REVENUE ADMINISTRATION: PROCEEDINGS OF THE 36TH ANNUAL CONFERENCE OF THE NATIONAL ASSOCIATION OF TAX ADMINISTRATORS (1968)).

2. *See, e.g.,* Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244, 244 (1969) (crediting Walter Blum with criticizing "administering [a] subsidy by way of a tax preference"); Walter Blum, *The Effects of Special Provisions in the Income Tax on Taxpayer Morale*, *in* JOINT COMM. ON THE ECON. REP., 84TH CONG., FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY 251, 252 (1955). Bittker further credits Walter Heller with the observation that there were "[g]overnment benefits which are . . . imbedded in the tax structure . . . [and] treated as inalienable vested rights." 3 H. COMM. ON WAYS AND MEANS, 86TH CONG., TAX REVISION COMPENDIUM 181, 190 (Comm. Print 1959) [hereinafter H. COMM. ON WAYS AND MEANS, TAX REVISION COMPENDIUM]. Given other suggestions of personal hostility, one may wonder whether Bittker was an impartial recounter of the history of the concept. Surrey himself seems always to have presented his contribution as the preparation of the budget and dated this idea to his remarks to the Money Marketeers, in November 1967, parts of which were included in the Annual Report of the Secretary of the Treasury for the Fiscal Year 1968, as discussed in Stanley S. Surrey & William F. Hellmuth, *The Tax Expenditure Budget—Response to Professor Bittker*, 22 NAT'L TAX J. 528, 528 (1969).

consensus about the structure of the income tax base was crucial to his proposal since his accounting would show the deviations from such a base that could not be justified within the norms of the income tax itself.

At the time Surrey began his campaign for a tax expenditure budget in the 1960s, much of the rest of the tax policy world was debating the usefulness of the concept of a comprehensive tax base that would more closely follow economists' views. This approach was, and still is, commonly associated with the "Haig-Simons"[3] definition of income. Under this approach, all accretions to wealth, even those not yet reduced to a cash equivalent, should be included in the tax base. If such a tax base could be perfectly implemented, its imposition would not influence economic behavior. However, the Haig-Simons approach is almost universally understood to be impossible to implement. Not only does this approach create overwhelming problems with the timing of income, but it also exposes troublesome questions about the inclusion of values that are difficult to measure, including self-created values, values imputed from asset ownership, and benefits distributed by governments or in other non-market contexts. This theoretical approach arguably stood in the way of achieving the consensus about the nature of the tax base necessary for Surrey's purposes.[4]

Surrey did not let these more abstract debates dissuade him. In his early formulations of the tax expenditure concept, he acknowledged others' invocation of Haig-Simons but dismissed it.[5] His goal was not to provide a normatively correct income tax base, but rather to develop enough in the way of standards for defining that base that potential deviations from these standards could be identified and evaluated. To Surrey, the benefits of compiling such a "hit list" far outweighed the costs of errors in inclusions and omissions from the list.[6]

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3. *See generally* Boris I. Bittker, *A "Comprehensive Tax Base" As a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967) (recounting this debate). A nice summary of the state of the debate is also found in Earl Thompson's review of a collection of key essays in the debate. *See generally* Earl Thompson, Book Review, 24 J. FIN. 189 (1969) (reviewing BORIS I. BITTKER, CHARLES O. GALVIN, R.A. MUSGRAVE & JOSEPH A. PECHMAN, A COMPREHENSIVE INCOME TAX BASE? A DEBATE (1968)).

4. In addition to Bittker, among the most forceful critiques of the possibility of a consensus about the concept have included Douglas A. Kahn & Jeffrey S. Lehman, *Tax Budget Expenditures*, 54 TAX NOTES 1661, 1663 (1992) and Bruce Bartlett, *The End of Tax Expenditures as We Know Them?*, 92 TAX NOTES 413, 419 (2001) ("The most fundamental problem is the implicit assumption that there is some ideal tax system against which to judge tax preferences. The result is that the decision to include or not include a particular item is totally arbitrary.").

5. *See, e.g.*, U.S. TREASURY DEP'T, ANNUAL REPORT OF THE SECRETARY OF THE TREASURY ON THE STATE OF THE FINANCES FOR THE FISCAL YEAR ENDED JUNE 30, 1968, 329 (1969) [hereinafter U.S. TREASURY DEP'T, ANNUAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 1968]; STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES 12 (1973).

6. For instance, Surrey was unconcerned with identifying "negative tax expenditures," items that included more in the tax base and therefore punished taxpayers in ways that might substitute for sanctions outside the tax system. This omission was pointed out early on. *See* Alan L. Feld, Book Review, 88 HARV. L. REV. 1047 (1975) (reviewing SURREY, *supra* note 5). It was also discussed seriously in testimony of Norman Ture before the Senate Budget Committee in 1981, but it was not acted upon until negative tax expenditures were discussed in a Joint Committee publication. *See* JOINT COMM. ON TAX'N, BACKGROUND INFORMATION ON TAX EXPENDITURE ANALYSIS AND HISTORICAL SURVEY OF TAX

Of utmost importance in developing this consensus regarding the income tax base was establishing a norm regarding the expenditures that should be allowed as deductions, reforming the income tax into a tax on net income rather than one on gross income. Surrey believed it was possible to identify those items that "are directly related to the measurement of net income appropriate to an income tax."[7] His hit list made normative distinctions between which items should and should not be deducted. In any common sense understanding of an income tax, deductions must be allowed for expenditures made in anticipation of generating immediate income. But given the fact that many expenditures serve personal as well as income-seeking purposes, distinguishing between the two is difficult. And, as discussed below, such a norm did not emerge simply by virtue of the fact that the tax was advertised as a tax on incomes.

In 1957, long before he put forward his proposal for a tax expenditure budget, Surrey had claimed with some certainty that the income tax must be assumed to be a net income tax:

> An income tax is a net income tax, and as such should certainly make allowance for expenses incurred in earning the income taxed. The law thus properly allows a deduction both for business expenses and for nonbusiness expenses incurred in producing income or maintaining property held for the production of income.[8]

Under such a net income norm, all costs expended in the pursuit of income includable in the tax base should be allowed as offsets. These offsets can take the form of both expenses and losses; the latter includes "loss" both in the sense of expense exceeding income in any given taxable period and in the sense of realization of less than the amount invested in a position. Both should presumptively be allowed to offset all income, unless there are specific justifications for denying them.[9]

But did such a net income norm actually exist? Much debate had surrounded this question in the 1930s and early 1940s, when Surrey first served in the

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EXPENDITURE ESTIMATES (Feb. 6, 2015), https://www.jct.gov/publications/2015/jcx-18-15/ [https://perma.cc/4ACA-VB4E].

7. This formulation was used in the first formal presentation of the tax expenditure budget. Surrey was apparently not interested in developing a phrase as a technical term of art, since elsewhere in the same report, the concept was described as "all the provisions which vary from a strict definition of net income," and "widely" or "generally accepted" measures of net income." *See* U.S. TREASURY DEP'T, ANNUAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 1968, *supra* note 5, at 326–27, 329.

8. Stanley S. Surrey, *The Income Tax Base for Individuals*, *in* INCOME TAX DIFFERENTIALS 34, 47 (Dan Throop Smith et al. eds., 1958) (reproducing papers given at a symposium held on Nov. 21, 1957). Essentially the same paper, and the quoted passage, was published as Stanley S. Surrey, *The Federal Income Tax Base for Individuals*, 58 COLUM. L. REV. 815, 824–25 (1958) and included in H. COMM. ON WAYS AND MEANS, TAX REVISION COMPENDIUM, *supra* note 2, at 9.

9. The specific reasons for denying deductions and losses most commonly involve problems with mismeasurement as a result of taxpayer control of timing (for example, limitations on capital losses), of mismatching of character (for example, deduction of investment expenses in excess of investment income), of more subtle forms tax avoidance that rely on imperfect enforcement (passive activity losses and at-risk requirements), and of general inadministrability (for instance, employee business expenses). These provisions are not inconsistent with a net-income norm so long as they are justified, especially in the rare case in which complete denial of any tax benefit is the result of the limitation.

Treasury Department.[10] As discussed in more detail below, the government had repeatedly asserted positions that would deny taxpayers the costs of earning income in the past. Why did Surrey have such confidence that a net income norm could be established, and that with it, deductions inconsistent with this norm could be identified?

One source of Surrey's confidence that some structure could be given to the income tax is almost surely his work as the Reporter for the American Law Institute (ALI) Income Tax Project, which began in 1947. In working on this project, Surrey was exposed to two aspects of the tax policy world that would solidify his view. First, he worked with other academics, especially John McGuire and Erwin Griswold, who had publicly asserted similar views. Second, he also worked with tax practitioners who, despite their extensive experience of the chaos of the then-existing law, had joined ranks to try to find a structure for the income tax base. Although the ALI's articulation of this norm (providing deductions for all expenses related to "gainful activities") was never embraced by Congress,[11] identification of the need to create such a concept and the articulation of the necessary language were among the earliest accomplishments of the project.

This article will first outline some aspects of the history of the income tax that explain the persistence of government positions inconsistent with a net income norm. It will then examine the steps taken in the ALI Tax Project, in which Surrey was among the early organizers, toward establishing this norm.

II

THE ARBITRARINESS OF THE EARLIEST STATUTES AND FORMS

Statements to the effect that the income tax in the United States was always intended to be a tax on net income rather than gross income are easy to find. In 1914, Cordell Hull, largely credited with drafting the 1913 Act,[12] described the new tax as "essentially a tax on gains and profits. Naturally all laws prescribe the allowance of certain deductions necessary to the computation of such gains and profits."[13] Prior to the 1940s, however, such statements were, at best, wishful

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10. *See infra* notes 34–47 and accompanying text.

11. *See infra* note 55 and accompanying text.

12. *See generally* LAWRENCE ZELENAK, CORDELL HULL WRITES THE INCOME TAX 1–25 (2018) (examining the enthusiasm of Hull (as well as his willingness to overlook some details in his proposals)).

13. Cordell Hull, *Some Features of the New Income Tax Law*, *in* NEW YORK STATE BAR ASSOCIATION: PROCEEDINGS OF THE 37TH ANNUAL MEETING 132 (1914). This section of his speech was rather disingenuously entitled "Deductions always allowed." Hull further noted "[t]he legitimate expenses and losses of a business or businesses from which profits are derived always constitute a proper deduction," without acknowledging that the Treasury had already ruled denying deductions using a definition of "business" that did not include all income-producing activities. ROBERT H. MONTGOMERY, INCOME TAX PROCEDURE 120 (1917). Other observers were less certain that such generalizations regarding the net nature of the tax were possible. The treatise writer and dictionary compiler Henry C. Black in his 1913 work on the prior income taxes noted that the interpretation of "income" as implying net or gross had been a perennial issue. *See* HENRY CAMPBELL BLACK, A TREATISE ON THE LAW OF

thinking. The earliest income taxes in the United States, imposed to fund the Civil War, were administered with very little sense of the need to establish a coherent structure for the tax base. The early taxes clearly did not result in a tax only on net incomes. Instead, Congress merely provided, in varying formulations, that the tax must be paid on income from all sources. It left few clues about whether income meant all receipts, all profits, or something else entirely. Although taxes and interest were made deductible without regard to their relationship to any particular income stream, other expenses were hardly addressed.[14]

The forms for reporting income, moreover, tended to require that the income from each source be listed separately. These forms usually included no obvious way to report offsets to each source of income for the costs of obtaining it. In 1862, for instance, Form 24 required that the gross amounts from thirteen specified sources be separately reported. It ended with a fourteenth category that encompassed all remaining sources. This last category of income was intended to cover operating businesses; here, expenses could obviously be taken into account. Various types of allowable deductions were described on the forms and could be reported in the aggregate, but the forms did not require including any additional information showing any particular relationship to the production of those sources of income.[15]

This approach in the forms was the one that had been used in the most successful earlier income tax. This approach had relied heavily on withholding by payors at the source, with many specific sources separately reported.[16] Since withholding agents cannot be expected to take into account the expenses of their payees, withholding at the source works best if used only on those income streams for which costs can be ignored without producing great inequity. Thus, withholding could work well for interest, rents, royalties, and similar predictable income streams that likely involve little variation in expenses incurred across taxpayers. When these income streams were reported as gross amounts, no great

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INCOME TAXATION UNDER FEDERAL AND STATE LAWS 74–76 (2d ed. 1915).

14. The first of the Civil War income tax enactments, the Revenue Act of 1862, provided that "any kind of property, rents, interest, dividends, salaries, or from any profession, trade, employment, or vocation carried on in the United States or elsewhere, or from any other source whatever" would be subject to tax. Revenue Act of 1862, ch. 119, § 90, 12 Stat. 432, 473 (1862). More specificity was provided in later acts as to deductions that were allowed or disallowed, but no effort was made to provide an overall framework. *See, e.g.,* Section 117 of the Act of Mar. 3, 1865, *reprinted in* GEORGE S. BOUTWELL, THE TAX-PAYER'S MANUAL: CONTAINING THE ENTIRE INTERNAL REVENUE LAW 13 (1866). The 1894 act language was almost identical with respect to income, but also expressly provided that "the necessary expenses actually incurred in carrying on any business." Act of Aug. 27, 1894, ch. 349, § 27, 28 Stat. 509, 553 (1894).

15. The specified deductions were: "Expenses necessarily incurred and paid in carrying on any trade, business or vocation," "amounts actually paid by a property owner for necessary repairs, insurance, and interest on incumbrances from his property," and similar amounts paid by farmers. Reproductions of these forms can be found in GEORGE S. BOUTWELL, A MANUAL OF THE DIRECT AND EXCISE TAX SYSTEM OF THE UNITED STATES 156 (1863).

16. Addington's income tax of 1803 was the first to require particular returns from particular sources combined with withholding at the source. *See* B.E.V. Sabine, *Great Budgets*, 1970 BRITISH TAX REV. 330, 334 (1970).

inequity is created across taxpayers receiving these types of income. But for the more irregular income reported in the business schedule, no attempt was made to withhold, since withholding on gross amounts paid would create substantial inequity while withholding on the net income resulting from the payment would be administratively impossible. Neither the regulations nor the forms provided taxpayers with instructions for seeking relief if they had incurred unusual costs in connection with non-business income upon which withholding had been required. The same was true for taxpayers who sought relief in transactions involving overall losses.[17]

The 1913 Income Tax, the first enacted after the ratification of the Sixteenth Amendment that same year, was similarly noncommittal about the meaning of was similarly noncommittal about the meaning of "income." Rather, it was levied on "the entire net income arising . . . from all sources."[18] The statute did, however, include a short list of the deductions that would be allowed. But again, not all these deductible costs needed to be connected to the pursuit of income; taxes and interest were deductible regardless of the activities they supported. And the language of the statute suggested that any other costs would be deductible only if they were related to "carrying on any business," even if they led to taxable receipts. No mention was made of costs outside of a "business," or of the meaning of "business" for the purposes of the statute.[19]

The compliance provisions in the 1913 statute similarly disregarded the implications of claiming net income as the starting point for the tax base, instead requiring that taxpayers "[set] forth specifically the gross amount of income from all separate sources and from the total thereof, deducting the aggregate items or expenses and allowance herein authorized."[20] In other words, all items of income (presumably all receipts) were to be reported initially separately and without any offsets. This reported gross amount was then to be offset only by the total of items specifically authorized as deductions. Again, the connection between income sources and deductions was obscured.

The potential ambiguity about the nature of income that was taxable under the 1913 Act is even more clearly demonstrated by the Treasury's position with respect to losses on investments made by an individual not clearly in the "business" of investing. In T.D. 2135,[21] the Treasury flatly ruled that investment

17. *See generally* ZELENAK, *supra* note 12, at 29–63 (discussing the role of withholding in the administration of the 1913 Act). Withholding on gross amounts remained (and remains) the norm for non-U.S. taxpayers, but because of the limited base to which the income tax applies, this practice does not appear to create a substantial deviation from a net income norm.

18. Income Tax Law of 1913, Pub. L. No. 16, ch. 16, 38 Stat. 114, 166 (1913). The act did provide for losses incurred "in trade," a provision which had prompted a discussion in the Senate about whether offsets should be allowed only for the costs of "legitimate" activities. Senator Sterling failed in his efforts to amend the provision to limit losses to those involved in lawful or legitimate activities, specifically to deny offsets against other income for gambling losses. *See generally* JACOB S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 996 (1938).

19. Income Tax Law of 1913, Pub. L. No. 16, ch. 16, 38 Stat. 114, 167 (1913).

20. *Id.* 38 Stat. 114, 168.

21. *See* 17 TREASURY DEP'T OFFICE OF COMM'R OF INTERNAL REVENUE, TREASURY DECISIONS

gains could not be offset by investment losses incurred in the same year. The statute was promptly amended, first in 1916 to allow such losses to offset gains, then in 1918 to allow them to offset of all other income streams.[22] The legislative history suggests that at least some in Congress were becoming frustrated by the Treasury's inflexibility in its position limiting deductions to, quite literally, only those items specifically described in the statute without regard for the implications of a tax base purportedly imposed on income.[23]

III
DECADES OF CONTINUED UNCERTAINTY ABOUT THE MEANING OF "NET" IN A "NET INCOME" TAX

The call to allow more expenses and losses, and thus to conform to something closer to a net income norm, had been made by some of the most well-known advocates of the income tax. The National Tax Association had sponsored a Committee on the Federal Income Tax, which had recommended undoing T.D. 2135 so that offsets would be allowed for investment losses and business losses.[24] One member of this committee was especially harsh in his assessment of the Treasury's activity:

> The government naively takes the attitude that having declared many untaxable things taxable, and having refused to permit as allowable deductions many things which were so intended under the law, there is nothing for a taxpayer to do but submit. No income tax law in the history of the world was ever successfully administered under such a policy. . . . The federal law will likewise fail if not intelligently administered.[25]

Almost immediately, taxpayers brought their objections to government's positions on the meaning of "income" into the federal courts. The Supreme Court initially signaled disinterest in monitoring Congress's implementation of its newly acquired power and indicated that it would not give constitutional content to questions involving the disallowance of offsets to income.[26] But the Court soon reversed itself and signaled a willingness to interpret the statute's use of "net income" to distinguish taxable income from nontaxable recovery of capital.[27] And

UNDER INTERNAL REVENUE LAWS OF THE UNITED STATES 39, 43–45 (1915). This Treasury Decision incorporated a number of other positions relevant to the discussion here: the nondeductibility of the costs of trust administration, that is, costs that "reduce the income accruing to beneficiaries, but not the estate itself," the deductibility of losses in one business against income from another, and losses on stock trades.

22. Revenue Act of 1916, § 5(a), 39 Stat. 756, 759 (1916); Revenue Act of 1918, § 214(a)(5), 40 Stat. 1057, 1067 (1918).

23. SEIDMAN, *supra* note 18, at 966.

24. *See generally* NAT'L TAX ASS'N, REPORT OF THE COMMITTEE ON THE FEDERAL INCOME TAX (1915).

25. MONTGOMERY, *supra* note 13, at iv.

26. Stanton v. Baltic Mining Co., 240 U.S. 103, 112–13 (1916) (suggesting the Court would not give constitutional content to the offsets allowed). This statement was effectively dicta because in reaching its decision, the Court relied heavily on its decision in Stratton's Indep. v. Howbert, 231 U.S. 399, 414 (1913), which held that Congress had the power to impose an excise tax on corporate income regardless of its power to impose an income tax on individuals.

27. *See, e.g.,* Doyle v. Mitchell Bros. Co., 247 U.S. 179, 184–86 (1918) (allowing an offset for the value of standing timber at the time the corporate income tax first went into effect).

in *Eisner v. Macomber* (1920), the Court made an unambiguous claim to more general oversight of the Treasury's positions in defining income both as a constitutional and statutory matter.[28]

Although the Court never explicitly held that provisions denying deductions could render the income tax unconstitutional, it did signal that it might eventually do so.[29] A tax that arguably taxed more than income—because it did not scrupulously allow for costs—was vulnerable to claims that it was a tax on capital and wealth, which would render it inconsistent with the meaning of an income tax under the Sixteenth Amendment. As one author put the situation:

> The authorities, therefore, do not warrant a definitive answer to the questions whether the sixteenth amendment permits the adoption of a gross income concept or requires the adoption of a net income concept, the most that can be said is that they have permitted the former in certain situations, and justify the view that they require the latter in certain other situations.[30]

With this change in the Court's attitude, the Treasury retreated somewhat from its early stubbornness and showed a willingness to allow more receipts to be treated as returns of capital, and otherwise to allow for cost offsets than might otherwise have been viewed as not authorized by statute.[31] Eventually, it seems to have accepted taxpayer-favorable positions as expedient compromises without necessarily offering any published guidance.[32] There is considerable evidence that taxpayers who claimed offsets that were not specifically provided for either in the regulations or the statute were not challenged.[33] Such an approach would allow the entire system a chance to get up and running smoothly, without constant uncertainty resulting from litigation that resulted in judicial rejections of Treasury positions. Under this approach, the intuitions inherent in accounting for run-of-the-mill income-producing activities became more relevant than the prior curmudgeonly interpretations of statutory language.

In short, at least some administrators seem not to have placed high priority on picking fights with taxpayers about the allowance of nonbusiness but for-profit expenses and losses. It seems likely that taxpayers became accustomed to claiming expenses and overall losses for costs relating to transactions entered into for profit.

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28. *See* 252 U.S. 189, 192 (1920) ("And if . . . such a dividend is not to be regarded as 'income' or 'dividends' within the meaning of the act of 1913, we are unable to see how it can be brought within the meaning of 'incomes' in the Sixteenth Amendment").

29. *See* Burnet v. Sanford & Brooks Co., 282 U.S. 359, 362–63 (1931) (assuming for the sake of argument that there is a constitutional constraint on the meaning of income).

30. Henry Rottschaefer, *The Concept of Income in Federal Taxation*, 13 MINN. L. REV. 637, 642 (1929).

31. This approach may have led to the pronouncements, including Sol. Op. 132, I-1 C.B 93 (1922), that much later were taken to suggest a constitutional component to basis recovery. *See, e.g.,* Murphy v. United States, 460 F.3d 79 (D.C. Cir. 2006), *vacated*, 493 F.3d 170, 177 (D.C. Cir. 2007).

32. For instance, cost of goods sold was apparently always allowed. *See* BUREAU OF INTERNAL REVENUE, INCOME TAX PRIMER 7–8 (1917).

33. *See* Brief for Rollin Browne as Amicus Curiae Supporting Petitioner at 5, Higgins v. Commissioner, 312 U.S. 212 (1941) (No. 253) (providing a strident statement of this point).

IV

CONGRESS IS FORCED TO ACT, BUT DOES SO INCOMPLETELY

For a number of years, then, the Treasury seems to have found no reason to provide much clarity regarding the availability of expenses and losses in an activity that did not amount to a business.[34] But in the 1930s, the government again began to develop litigating positions based on very literal interpretations of the statutory language. In particular, it began to challenge taxpayers who claimed deductions for the expenses they incurred related to investment activities, no matter how robustly those activities were conducted.

The government's position familiarly rested on the fact that the statute provided for deductions only for expenses related to a "trade or business" and, albeit with limitations, for "losses."[35] Other costs, no matter how large they were in relation to receipts and no matter how closely related to income-seeking activities, were not entitled to deduction. This position was ultimately accepted by the Supreme Court in *Higgins* v. *Commissioner*.[36] The result of the distinction in that case was that no deduction was allowed at all for the substantial non-business costs incurred by a taxpayer who maintained an office and staff to keep track of his investments.

Why did the government press this position, which in many ways was contrary to the proposition that by then had become accepted that income was a net rather than gross concept? It seems that the taxpayer in *Higgins* presented a situation that was a particular source of irritation to Treasury, since his substantial reportable income was almost exclusively interest from tax-exempt bonds. At his death in 1948, his portfolio was described as "the choicest aggregate of outstanding tax-exempt obligations to be offered to the market at one time since before the war."[37] Since the statute contained no rule clearly denying deductions relating to tax exempt interest, like the one contained now in Section 265,[38] the only argument that could be made was the far broader argument that no deductions were allowed for the costs incurred in producing any type of investment income. And so, although having made more limited arguments in lower courts, the government argued to the Supreme Court that there simply was no authority for any deduction for costs related to investment activity.

The government's victory in *Higgins* was extremely short-lived. Section

34. The problem was still obvious to some outside the government. *See, e.g.,* George E. Holmes et al., *Simplification of the Income Tax: Report of Committee of the National Tax Association*, *in* 20 PROCEEDINGS OF THE ANNUAL CONFERENCE OF TAXATION UNDER THE AUSPICES OF THE NATIONAL TAX ASSOCIATION 108, 147–148, 153–54 (1927) (recommending that non-business losses be allowed and urging that the provision generally allowing deductions be amended to read "all actual expenses pertaining to the production of the net income of the taxpayer").

35. Internal Revenue Code of 1939, ch. 2, 53 Stat. 1, 23, § 23(a); (e) (1939).

36. 312 U.S. 212 (1941).

37. *Wide Bidding Seen for Higgins Bonds: $18,663,000 Offering of Choice Municipals by U.S. Trust Likely to Attract Bankers*, N.Y. TIMES (May 21, 1949).

38. *Compare* Internal Revenue Code of 1939, ch. 2, 53 Stat. 1, 16, § 24 (1939) *with* I.R.C. § 265. *See also* S. REP. NO. 73-558, pt. 2 (1939).

23(a)(2), the predecessor of Section 212, was added in October 1942,[39] clearly in response to the government's winning position in *Higgins*.[40] In language that still appears in Section 23(a)(2), Congress restored deductions for amounts expended "for the production or collection of income" and "for the management, conservation, or maintenance of property held for the production of income."[41] The Senate had actually sought an even more prompt response to the government's litigating positions in *Higgins* and similar pending cases, which the Senate had previously proposed to be included in the Revenue Tax of 1941. Upon assurances from Treasury that a fix would be forthcoming, the Senate was apparently willing to wait until the next major piece of tax legislation—an inevitable development given the recent full outbreak of World War II.[42] Tellingly, when this legislation was enacted, allowance of non-business investment expenses was made effective as if this articulation of the net income norm had been in effect for all prior revenue acts.[43] The government's sweeping position in *Higgins* was apparently to be purged from the income tax law.[44]

The debate triggered by the *Higgins* litigation rekindled discussions about the way in which the government should approach the interpretation of the income tax statute. More specifically, the post-*Higgins* debate questioned whether these interpretations should conform to a net income norm or whether there should be a presumption against the deductibility of expenses even those with no conceivable personal components. In their 1940 summary of the evolution of the income tax base, Gladys and Roy Blakey merely noted that the question of whether income meant "gross" or "net" was one of the most significant interpretive problems in administering an income tax, but that they could only repeat that the Supreme Court had said that it was willing to allow Congress "to

39. Revenue Act of 1942, Pub. L. No. 753, § 121, ch. 619, 56 Stat. 798 (1942). Section 214 of the Act further allowed losses 'if incurred in any transaction entered into for profit, though not connected with the trade or business." *Id.* at § 214.

40. *See, e.g.*, 88 CONG. REC. 6376 (1942) (statement of Rep. Wesley E. Disney) (stating how the judiciary can interpret provisions in a manner that is contrary to the interpretations of the Treasury and Bureau of Internal Revenue).

41. *See* Revenue Act of 1942, Pub. L. No. 753, § 121, ch. 619, 56 Stat. 798, 819, § 23(a)(2) (1942).

42. A conference report indicates that Treasury had agreed to block the Bureau from pursuing the fruits of its victories in *Higgins*:

The conferees have deferred action on the merits of this amendment with the understanding that it will be considered in a later bill dealing with administrative matters. They were advised by the Treasury Department that wherever possible final decision by the Bureau of Internal Revenue on issues arising under the *Higgins v. Smith* decision would be deferred pending such later legislation. The Senate recedes.

H. R. REP. NO. 77-1203, at 12 (1941).

43. Revenue Act of 1942, Pub. L. No. 753, § 121(d)–(e), ch. 619, 56 Stat. 798, 819 (1942). Before the adoption of the 1939 Code, the income tax law was reenacted not quite every year as if it were a new statute, with each section effectively being reenacted.

44. Unfortunately, the introduction in the 1944 Act of the standard deduction and the provisions defining "adjusted gross income" resulted in reinstatement of the problems inherent in distinguishing among types of receipt producing activity now found in sections 62, 67, 183, 165 and 212. These problems have produced far more confusion and inequity since the introduction of limits on miscellaneous itemized deductions in section 67. *See generally* Charlotte Crane, Legislative Disgrace (unpublished manuscript) (on file with author).

condition, limit, or deny deductions from gross income in order to arrive at the net that it chooses to tax."[45]

In a scathing criticism of the state of the tax law, James M. McGuire, a Harvard Law professor who would soon become a strong supporter of Surrey and the ALI project, took aim at both the Treasury and the Justice Department. He described the overall lack of coherence in the Treasury's positions, including the treatment of nonbusiness expenses, as involving "much official misjudgment," leading to the "business not merely of marching up a hill and then marching down again, but of fighting and bleeding to capture the hill, only to conclude that it was not a proper object of attack?"[46]

In 1943, in an essay in the Harvard Law Review, Erwin Griswold challenged the reliance on strict interpretation of statutory language instead of on common sense, and the lack of attention to Congress's purpose, both important components of the government's position in *Higgins:*

> [The doctrine strictly interpreting language permitting deductions because deductions were entirely a matter of legislative grace] has never been fully considered by the Court. Taken literally, it would mean that Congress may deny all deductions and impose a tax on gross income. This is a large question, about which there may be reasonable doubts, even today. Could Congress, for example, impose the tax on the entire proceeds from the sale of property without any allowance for the cost of the property? Could it deny all deduction for wages paid? But there is no need to resolve such questions, nor to deny that Congress has very great power over the deductions which are allowed. The fact remains that Congress has never sought to tax gross income. We are not dealing with a question of power, but of intention. And the whole structure and the history of the income tax makes it plain that the intention of Congress to allow deductions has been just as clear as its intention to tax income. . . .
>
> Much of the controversy has revolved around the matter of deductions for business expenses. The statute allows the deduction of "All the ordinary and necessary expenses paid . . . in carrying on any trade or business." This language has been unchanged since the Revenue Act of 1918. Apparently it finds its origin in provisions which were included in the Act of August 27, 1894. The legislative history of those provisions gives clear evidence that they were intended to have broad application; and no action of Congress since that time has ever indicated a contrary intention. *There would seem to be every reason why the words of the statute should be given a broad construction so as to achieve the obvious purpose of Congress to tax net business income*. . . . But the Court, by bearing down on "ordinary and necessary," and on "trade or business," and reducing these phrases to sterile bones, has done much to thwart the purpose of Congress to impose the tax on net incomes.[47]

But nothing was done to either provide a more rational statute or direct the government to change its approach when litigating the meaning of the admittedly flawed statute.

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45. ROY G. BLAKEY & GLADYS C. BLAKEY, THE FEDERAL INCOME TAX 481, 484 (1940) (quoting Helvering v. Indep. Life Ins. Co., 292 U. S. 371, 381 (1934)).

46. John M. Maguire, *Federal Revenue - Internal or Infernal*, 21 TAXES, Feb. 1943, at 77, 123. The Treasury positions on nonbusiness expenses and losses were a particular source of consternation.

47. Erwin Nathaniel Griswold, *An Argument Against the Doctrine that Deductions Should be Narrowly Construed as a Matter of Legislative Grace*, 56 HARV. L. REV. 1142, 1144–45 (1943). Griswold was a member of the Harvard Law Faculty with whom Surrey had met while he was working at Treasury and who was soon to bring Surrey there. *See* STANLEY S. SURREY, A HALF-CENTURY WITH THE INTERNAL REVENUE CODE: THE MEMOIRS OF STANLEY S. SURREY 36, 111 (Lawrence A. Zelenak and Ajay K. Mehrotra eds., 2022).

V

TOWARD STRUCTURAL NORMS: THE ALI INCOME TAX PROJECT

In the almost four decades since the enactment of the 1913 Income Tax, there was no attempt to provide any rational structure for the income tax base, even with respect to the simplest questions regarding the allowance of deductions for costs in the pursuit of income. The ALI Income Tax Project, started in 1947, attempted to set out such a structure.[48] Surrey, who had just left the Treasury to become an academic, was named the project's Reporter. In the earliest stages of the project, Surrey was assisted by a small policy committee that included Erwin Griswold and John M. McGuire, who would each become Surrey's colleagues on the faculty of Harvard Law School.

The project was a bit unusual for the ALI. The income tax was entirely a statutory creation, not the product of judicial reasoning, so the project could only be aimed at rationalizing the statute. But the project could make interpretation of the statute more amenable to judicial reasoning by providing logical principles for the judiciary to follow. One significant move toward that goal was the rationalization of the treatment of income and of income-producing costs.[49] This particular issue emerged as a priority in the earliest outlines of the topics to be addressed in the project. A "re-exam[ination] of [the impact] of section 23(a)(2)" and issues relating to employee business expenses were second only to issues relating to tax and financial accounting conformity generally under the general heading "Deductions in General."[50] The first step proposed was the elimination of "ordinary and necessary."[51] Specific language on capitalization and a public policy limit was offered in substitution. The comments made it clear that no longer would "any expense fail[] of deduction . . . on the ground that, while it was an expense (and not a capital expenditure) it was extraordinary in nature."[52]

The next step involved a consolidation of the provisions allowing deductions related to income into a single new provision, first numbered section X31. An early draft allowed individuals a deduction for any expense except a "personal, family or living expense."[53] To refer to those expenses that would be allowed, this early draft used the descriptions of income-producing endeavors from the numerous places they appeared in the earlier statutes. Thus, a personal expense

48. *See* Lawrence Zelenak, *The Almost-Restatement of Income Tax of 1954: When Tax Giants Roamed the Earth*, 79 BROOK. L. REV. 709 (2014) (tracing the history of this effort).

49. Efforts in the same spirit were made to alter the provisions limiting the use of overall losses in non-business activities available to reduce unrelated income.

50. AM. L. INST. INCOME TAX PROJECT, TENTATIVE TOPICAL DIVISIONS AND PRINCIPAL POLICY QUESTIONS THEREUNDER 1, 9–10 (1948). Other topics included in this initial list, especially related to cancellation of indebtedness and the tax benefit rule indicated its author sensed that a more logical approach to the tax history of a taxpayer was possible.

51. AM. L. INST. INCOME TAX PROJECT, DRAFT OF PRESENT SECTION 22 – DETERMINATION OF GROSS INCOME 43 (1949).

52. *Id.* at 2, 41, 49.

53. *Id.* at 29.

was defined as an expenditure which "considering normal modes of life . . . has more of the characteristics of such an expense or loss than either (a) an occupational or business expense or loss (b) an expense or loss incurred in the production or collection of income, in the management, conservation, or maintenance of property held for the production of income or in any other transaction entered into for profit."[54]

In the initial set of notes accompanying these proposed changes, the intent of the change was made clear. The old approach assuming that no deduction would be allowed was replaced by the opposite presumption when any profit-seeking was involved:

> *The allowance of any expense or loss except one personal in nature.* This changes the emphasis of present law, which establishes the profit-seeking activities of Section 23(a) as affirmative standards which the taxpayer must meet. To the extent that there is an area between the allowable deductions of section 23(a) and the disallowed personal expense of Section 24(a)(1), the suggested provision changes present law by eliminating that area as a non-deductible area.[55]

Outcomes such as that urged by the government in the *Higgins* case, strictly limiting deductions for income-producing expenses without justification other than the incomplete language of the statute, would no longer be possible. The position taken by Griswold in response to the case was to prevail.

By the time the first draft was submitted for review by the ALI membership in May 1949, the language of section X31 had been simplified so that it referred to expenses related to all "gainful activities."[56] These expenses were to be distinguished from those that were personal, family or living expense or loss. The draft proposed that all such amounts relating to "gainful activity" and "employment" were deductible in computing adjusted gross income. These changes remained in the ALI's final proposal in 1954: All such costs were to be allowed under a single provision, conditioned on the presence of gainful activity. Gone was the mess created by the need to satisfy an ordinary and necessary requirement. Similarly expunged was the irrationality of attempting to distinguish business from lesser forms of income-producing activity. Tortured attempts to understand whether Congress ever intended to distinguish the

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54. *Id.* The new provision was titled "General expenses and losses of employment, business or other profit-seeking activities."

55. *Id.* at 49–50. The general problem was also acknowledged in the first draft of section X22 (which defined gross income), in which the circumstances under which even the phrase "gross receipts" should include some offsets for costs were examined. The comments note that "[t]his problem of gross receipts against gross income may need further exploration as respects the present statutory structure, which—like this revision—dodges the problem. Such dodging may in the end still be advisable." *Id.* at 12. The material available in the Hein Collection does not offer any clues about the authorship of most of the material included in it. Surrey's own description of the early days of the project suggest his close involvement. *See* SURREY, *supra* note 47, at 116–17 (providing Surrey's description of the early days of this project, suggesting his close involvement).

56. INCOME TAX STATUTE 60 (AM. L. INST., Tentative Draft No. 1, 1949). John McGuire was listed as a "special consultant" in this draft, and Erwin Griswold a member of the Tax Policy Committee. *See also* INCOME TAX STATUTE (AM. L. INST., Tentative Draft No. 2, 1950) (which was discussed by the full membership and left the provisions unchanged but numbered X151); INCOME TAX STATUTE (AM. L. INST., Questions Suggested by Reporters for Income Tax Statute Discussion on Friday and Saturday, May 19 and 20, 1950).

consequences of transactions entered into for profit from those of property held for the production would vanish.

Surrey described these changes as equitable and simplifying:

> There is now under consideration a proposed statutory arrangement which would divide an individual's deductions into two classes. The first class would include all the deductions relating to the pursuit of a business, employment, or other gainful activity. The second class would contain those personal, family, or living expenses which are allowed as deductions. . . . [A] useful statutory arrangement might take this form: (i) Deductions relating to gainful activity, to be utilized in computing standard net income. This group of deductions would encompass: (a) A general provision for the deduction of expenses and losses incurred in gainful activity, excluding for this step any personal, family, or living expenses. (b) Specific treatment where needed of particular deductions relating to gainful activity: depreciation and depletion, bad debts, net loss, bond premium, and deductions under present Section 126 relating to income in respect of a decedent . . . .[57]

Did Surrey himself share a sense that this presumption of deductions for all costs was fundamental to the income tax? Surrey had worked at the Treasury during the time that the government's litigation position in *Higgins* was most intensely pursued, and when the provisions that undid *Higgins* were proposed and finally enacted.[58] He surely understood the resulting state of the law, even if he felt no compelling need to remedy it.

Surrey conceivably could have had no role in setting the ALI project agenda so that it included reform of these the crabbed interpretations of the statutes that might have allowed deductions. But it seems clear that most of those with whom he engaged in the early days of the ALI project agreed that it was logical to group all such expenses as presumptively deductible so long as they were related to gainful activities. As a result of his efforts in this project, if not before, Surrey could anticipate that no matter how much debate there might be about the details, or how much effort should be put into specifying exceptions to such deductions for hobby losses and the like, there would be a consensus that expenses leading to taxable income should be deductible. This was all the consensus about the structure of the income tax that was necessary in order to make Surrey's tax expenditure budget proposal coherent. Indeed, even though this consensus was never incorporated into the statute, it would suffice as the touchstone for the presence of tax expenditures. Regardless of Surrey's views about the importance of adhering to a net income norm, his work on the ALI project gave him the sense that it was possible—at least among the lawyers most familiar with the statute—to form a consensus about the structural provisions at the heart of the income tax.

57. Stanley S. Surrey & William C. Warren, *The Income Tax Project of the American Law Institute: Gross Income, Deductions, Accounting, Gains and Losses, Cancellation of Indebtedness*, 66 HARV. L. REV. 761, 785 (1953).

58. *See* SURREY, *supra* note 47, at 51–52 (describing Surrey's work at the Treasury during this time which also apparently saw the enactment of an inclusionary limit on the tax benefit rule).

VI

CONCLUSION

In order to get the idea of the tax expenditure budget off the ground, Stanley Surrey had to hold firm to the idea that it was possible to articulate a consensus view about the fundamental structure of the income tax. A consensus about the treatment of expenses leading to taxable income would be especially important.

If Surrey had limited his inquiry regarding the possibility of such a consensus to the early history of the income tax, he would have undoubtedly been discouraged by the inconsistency of the positions taken by the government in litigation and accepted the courts. But these very inconsistencies fueled the debates through which of a workable consensus about the proper rules underlying the definition of income might emerge.

Alas, Congress did not take advantage of the moment to revamp the provisions relating to expenses incurred in gainful activity as suggested by the ALI drafts. Indeed, not only were the prior provisions distinguishing business expenses from expenses relating to other income-producing activity reinstated, but the Code was expanded by a plethora of provisions limiting the ability of taxpayers to take such deductions in various specific circumstances. Nevertheless, most observers of the income tax assume that at its core, the income tax is (and was always intended to be) a tax on no more than net income.[59]

59. The lack of a consensus for other existing taxes helps explain the lack of impetus for a tax expenditure analysis of those taxes. *But see* Lindsay Oldenski, *Searching for Structure in the Federal Excise Tax System: An Excise Tax Expenditure Budget*, 57 NAT'L TAX J. 613 (2004) (describing the failed attempt to provide a conceptual framework for federal excises); Bruce F. Davie, *Tax Expenditures in the Federal Excise Tax System*, 47 NAT'L TAX J. 39 (1994).